North South Gasoline Pricing Study

Ministry of Energy
Ontario

Honourable Vincent G. Kerrio
Minister

Energy Ontario

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NORTH SOUTH GASOLINE

PRICING STUDY

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EXECUTIVE SUMMARY

Retail gasoline prices are higher in northern Ontario than they are in the south. This is an issue of concern to residents of the north, who have frequently expressed the view that the price differences are larger than could be explained by differences in distribution costs.

To address these concerns, the Honourable David Peterson, in his speech to the legislature on July 2, 1985 announced that a study of price differences would be undertaken. This report is the result of that commitment.

The study examined the structure of the gasoline retailing industry, starting with its rapid development following the second world war. A detailed analysis of prices and the factors that affected them during the course of the study was undertaken, with particular emphasis on those factors where differences could be identified between northern and southern Ontario.

Several events which seem destined to have a profound impact on the future of gasoline marketing occured either during the study or so shortly before it that their effects could not be observed. These events include the implementation of the Western Accord, Petro-Canada's purchase of the Ontario assets of Gulf Canada Limited and the introduction by Imperial Oil of rack pricing. The implications of these events are discussed, but, because of their timing, the impact on the market could not be analysed.

Summary of Causes of Price Differences

While the retailing of gasoline is extremely complex, involving the interplay of a large number of factors, the principal causes of price differences can be stated as follows:

a) The market in the south is larger and therefore experiences more competition.

b) Average volumes per outlet are lower in the north, changing the retailers' attitudes toward gasoline and making them less aggressive.

c) The distribution and retailing of gasoline in the north are less efficient.

The study also found that:

Price Differences

(1) Northern retail gasoline prices are almost always higher than those in the south

This fact remains true even when there is no price war activity in the south.

(2) Price war activity occurs more frequently in the south

This increases the average difference in prices between north and south. Differences also occur between urban and rural centres, particularly in northern Ontario.

(3) The differences between urban and rural prices in northern Ontario are usually greater than those between northern and southern cities.

Cost Differences

Cost differences occur at both the wholesale and the retail level.

(4) Wholesale cost differences result from greater distribution costs in the north.

All Ontario's refineries are located near the major markets of southern Ontario. Distribution costs are higher in the north because of the greater distances and because the average station in the north is smaller, resulting in less efficient delivery.

(5) Retail cost differences are largely the result of lower average volumes in the north

The average station in the south sells about 75 per cent more gasoline than its northern counterpart. This has major impacts on unit costs and on sales of other products and services.

(6) In most cases, distribution cost differences exceed differences in price.

Only in severe price war situations do price differentials grow to the point where they exceed incremental distribution costs.

(7) Over the period of the study, the average difference in retail prices between north and south was 4.2 cents per litre.

(8) At this level of difference, the annual incremental cost to a northern motorist is about $130

This is based on a car driving 20,000 kilometres a year and consuming 3,000 litres of gasoline.

Market Differences

(9) Company operated stations, branded lessee dealers, jobber outlets and fighting brands are relatively more common in the south. Dealer owned stations both those displaying their own and refiner brands are relatively more common in the north.

(10) The overall market in northern Ontario is substantially smaller than that in the south. Less than ten percent of Ontario's population lives in the north.

Because of its greater area, communities in Northern Ontario tend to be isolated from one another. By contrast communities in the south are often close enough together to influence one another. As a result:

(11) The market for gasoline in the north is separated into a number of independent sub-markets, while that in the south is more homogeneous.

The larger size of the market in the south makes prices lower there for several reasons. A wider choice of brands is offered; traffic flow past stations is greater; stations are closer together; a greater mix of services is offered. All these factors have been identified as raising the level of competition and lowering prices.

Network Inefficencies

Several inefficiencies were uncovered in the retailing of gasoline. One is more significant than the others:

(12) There are more outlets than are required to serve the market. This lowers average volumes and raises costs, particularly in Northern Ontario.

The market is working to correct these inefficiencies, but the correction requires capital investments at a time when funds are scarce due to declining profits and the demand for funds for alternate users. Rationalization has tended to occur where the expected return on the capital invested is highest. This has usually been in the larger markets of southern Ontario.

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CHAPTER 1: INTRODUCTION

The market for gasoline in Ontario is undergoing a period of profound change caused mostly by a reversal of a long-standing growth trend which started in the years following the second world war and ended in 1980.

Declining markets for gasoline and other petroleum products have resulted in fierce competition among refiners to maintain sales at levels which allow them to operate their refineries efficiently.

In recent years, the industry has been characterized by refinery closures, increased market concentration, retail price wars and rationalization of the retail system. The last two of these effects were not felt evenly across the province. Together, they have resulted in an increase in the difference in gasoline prices between northern and southern Ontario.

This report analyses the price differences across the province, and seeks to explain them in terms of the forces at work in the marketplace.

Generally, the forces which affect the gasoline market are not clearly understood or accepted by the consumer. In particular, differences in gasoline prices between northern and southern Ontario have been cited frequently by residents of northern Ontario as being unreasonable or unjustified.

Ontario motorists spend more than five billion dollars annually on gasoline. Gasoline sales account for about 4 per cent of consumer expenditures. This is about half what the average consumer spends on clothing. But gasoline attracts a very high level of price consciousness on the part of consumers.

Like many other commodities, gasoline is more highly priced in northern Ontario than it is in the south. To understand the reasons underlying this phenomenon, it was necessary to examine in some detail the structure of the gasoline retailing market and the forces that affect it. The following report focuses on price differences between north and south and the reasons for them, but it also provides some insights into the overall working of the market, including the reasons for price differences within regions.

The report was prepared by the Ministry of Energy in cooperation with the Ministry of Northern Development and Mines.

SCOPE AND METHOD

The study is based on data available to the Ministry from its ongoing monitoring activities, data collected specifically for the purpose of the study and published data, including the results of previous studies.

Weekly pricing data were collected for seventy six communities in northern Ontario and twenty seven communities in southern Ontario during the period of the study, that is from July 3 to November 27.

Nine communities in northern Ontario and three in southern Ontario were selected for more detailed analysis. For each centre, locally hired students recorded all price changes over a period of one week. In addition, a complete description of the retail marketing network was obtained. Comparisons of the service station population uncovered key differences between north and south.

Interviews were held with the major oil companies operating in Ontario. They were asked to describe their distribution systems and provide comparative cost data for delivery to stations in different parts of the province. In addition, discussions were held with each on the market forces involved, with particular emphasis on those which resulted in price differences between northern and southern Ontario.

Various organizations involved in the industry were also interviewed. These organizations included those representing the refiners and both branded and independent dealers. As well, several individual dealers were interviewed.

A consultant knowledgeable in the gasoline retail industry provided background information on the retail industry and an independent assessment of the reasons for differences in prices. The consultant had access to all data collected in the study and assisted in its interpretation.

Inquiries into the pricing and marketing of gasoline have been conducted in the past. The reports of these studies were examined by the consultant.

The consultant also reviewed the experiences on this issue of other Canadian jurisdictions, as well as those of the United States and Europe.

The methodology used in this study is given in more detail in Appendix A. Summaries of the other studies are given in Appendix B.

CHAPTER 2: GASOLINE PRICE DIFFERENCES IN ONTARIO

HIGHLIGHTS

- Prices are higher in northern Ontario than they are in the south.
- Prices are more stable in northern Ontario than in southern Ontario.
- In northern Ontario, the smaller and more remote a community, the higher the price.
- The less accessible the market, the less price activity there is in the market.
- Over the course of the study, the average price difference between northern and southern Ontario was 4.2 cents per litre.
- However, toward the end of the study, the average price difference narrowed considerably.
- The additional cost to the northern motorist of higher gasoline prices is probably less than $130 per personal use vehicle.

Analysis of the information collected revealed several kinds of price differences. The following charts help explain them.

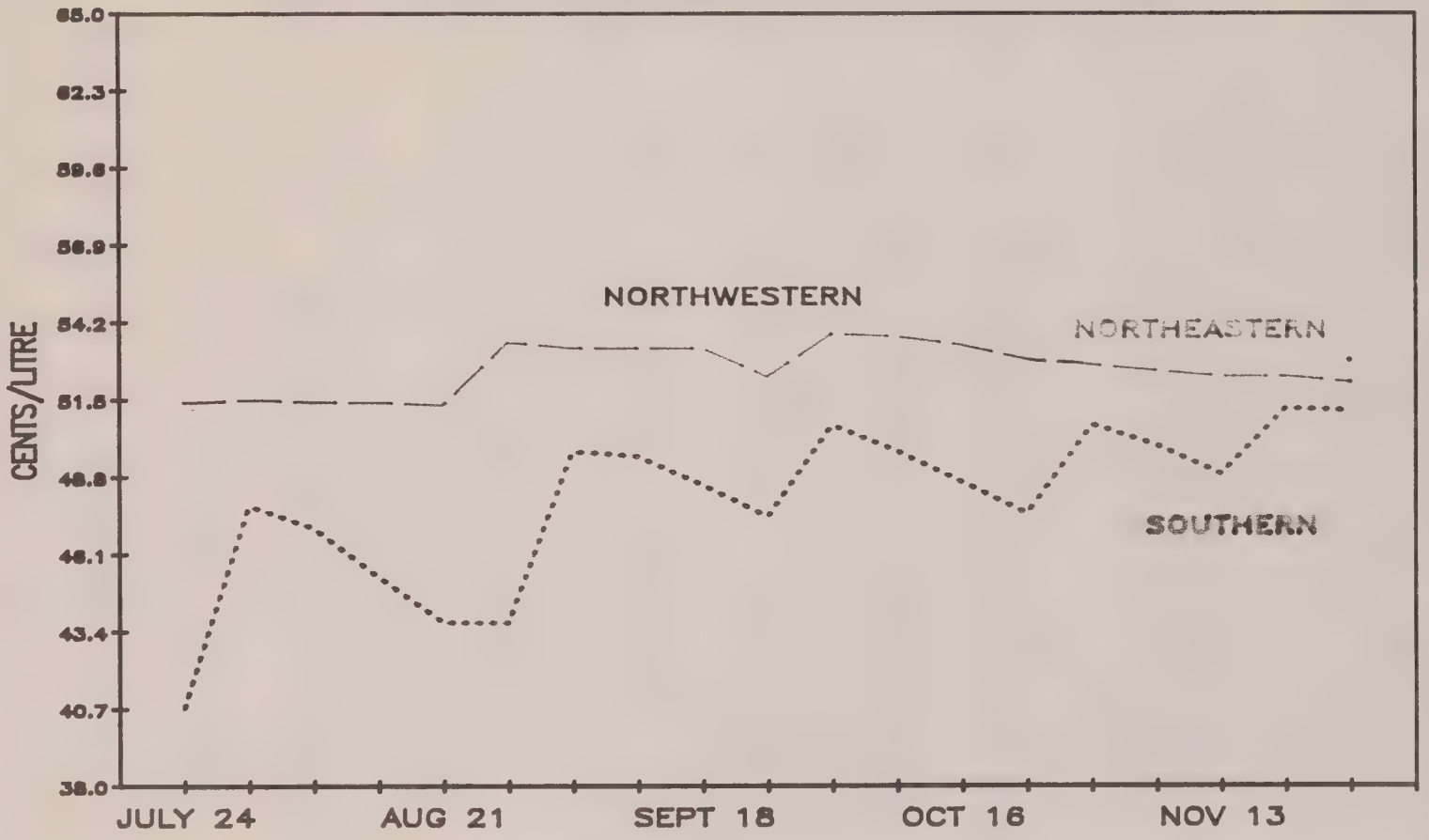
NORTH-SOUTH PRICE DIFFERENCES

In Figure 2.1 the surveyed locations are grouped into three geographic areas. For each group the average price is shown for a number of weeks. These averages show the following things:

- Average prices are higher in northern Ontario than in southern Ontario. Throughout most of the survey period, prices were slightly higher in the northwest than in the northeast. However, toward the end of the period, average prices in the northwest fell below those further east.
- Prices are more stable in northern Ontario than in southern Ontario.

Figure 2.1

NORTH VS SOUTH GASOLINE PRICES



SOURCE: ONTARIO GOVERNMENT SURVEYS

To understand these averages fully, it is important to know two things the figure does not show:

- The range of prices being averaged is much wider in the three northern areas than in the south. Of course the geographic areas they cover are many times that of southern Ontario. But across the south, prices in different locations tend to be much closer together than they are across the north.

- The averages are based on prices in surveyed areas only. They are weighted according to the population of each community. Thus they do not allow for variations in per capita consumption or for differences in the amount of out-of-town traffic.

Over the period of the study, prices in northern Ontario, on average were just over four cents per litre higher than those in the south.

PRICE DIFFERENCES AND COMMUNITY TYPES

Figure 2.2 shows another important characteristic of northern gasoline prices. The four northern communities named have been found to represent four different types of market. In size and in accessibility to urban centres they represent gradations:

- Thunder Bay - a major urban area

- Wawa - a town located on a major highway

- Foleyet - a small town located on a secondary highway

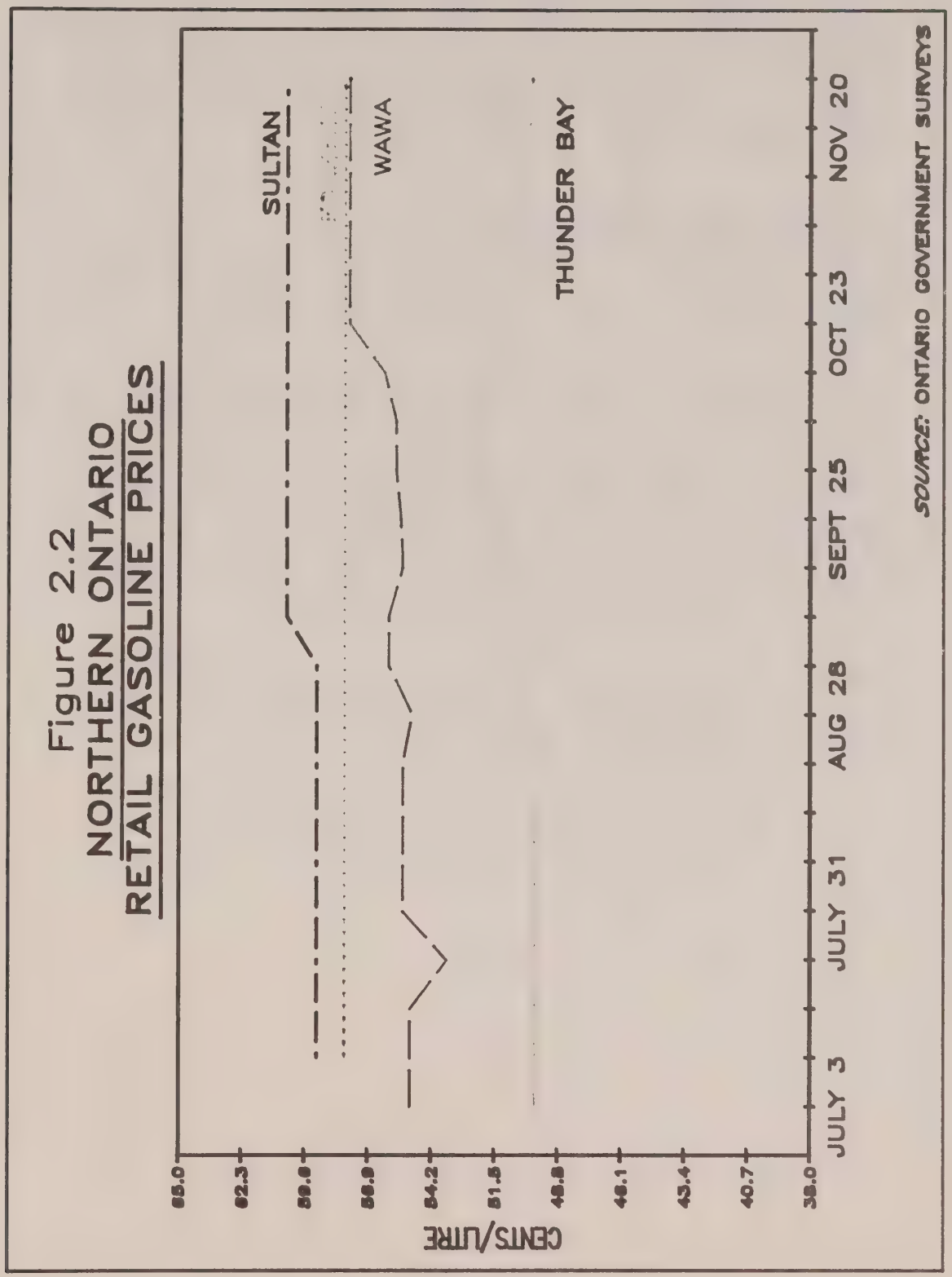
- Sultan - a village at the end of a minor highway.

The average gasoline prices in these northern communities have been plotted, and the results indicate the following conclusion:

- The smaller and more remote the community, the higher the price.

The number of service stations involved varies from community to community, so that an average price based on the total quantity of gasoline sold in the four communities would be much closer to the lowest average, that for Thunder Bay, than to the others.

Figure 2.2
NORTHERN ONTARIO
RETAIL GASOLINE PRICES



The survey results indicate that in explaining price levels community size is less important than remoteness. In both northern and southern Ontario, smaller communities near cities tend to reflect the city prices. In southern Ontario most small communities are close enough to cities to be influenced by them. The greater distances between cities in northern Ontario mean that smaller communities tend to be beyond urban influence and to have higher prices.

REGIONAL PRICE DIFFERENCES

Figure 2.3 shows average prices in three markets. These regional prices differ in both absolute level and variability.

The differences in variability are determined by local market forces. Toronto experiences continual and intense price wars; Sudbury has fewer wars, and they depress prices less; Hearst is nearly immune from price wars. The retail effect of the increase in federal excise tax on September 4 is visible for Hearst but is lost in the general market activity for Sudbury and Toronto. In general, the less accessible the market and the higher the prices, the less price activity there is in the market.

Figures 2.4 to 2.9 further illustrate the differences between northern and southern Ontario. They show pairs of communities with similar populations in northern and southern locations.

Figure 2.3
NORTHERN ONTARIO
RETAIL GASOLINE PRICES

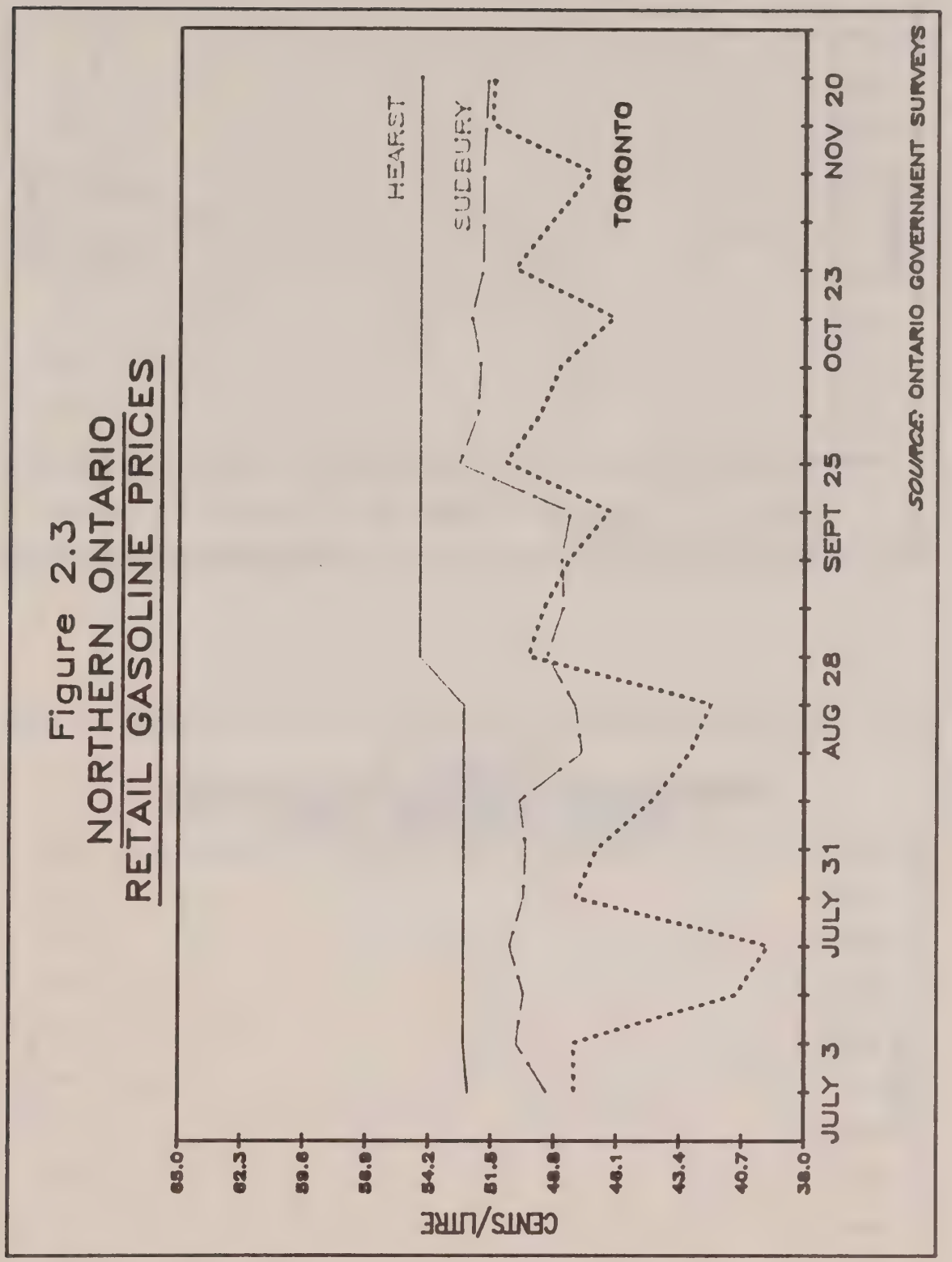


Figure 2.4
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES

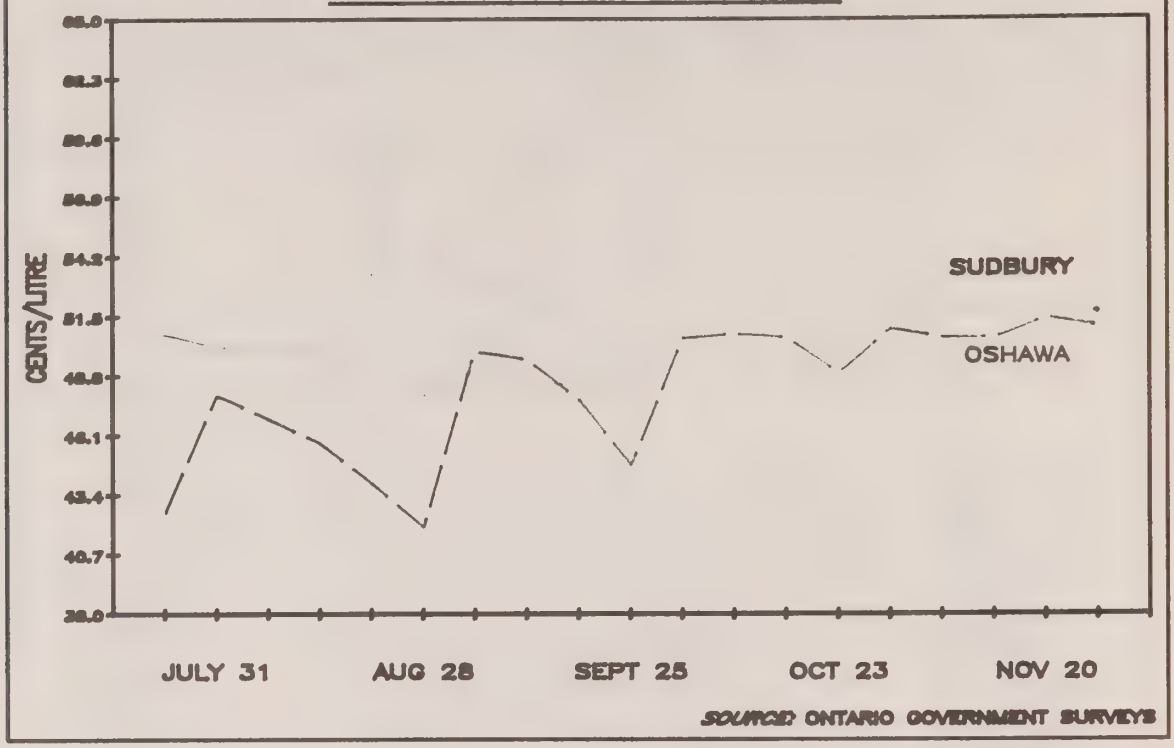


Figure 2.5
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES

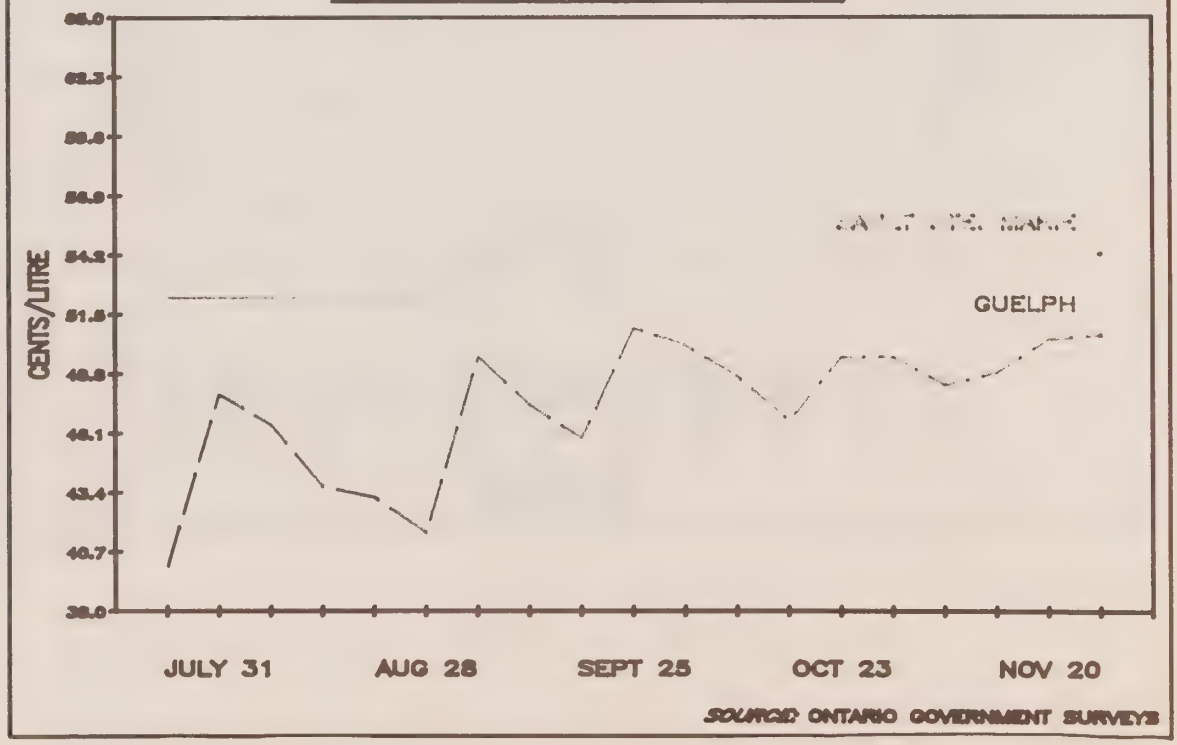


Figure 2.6
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES

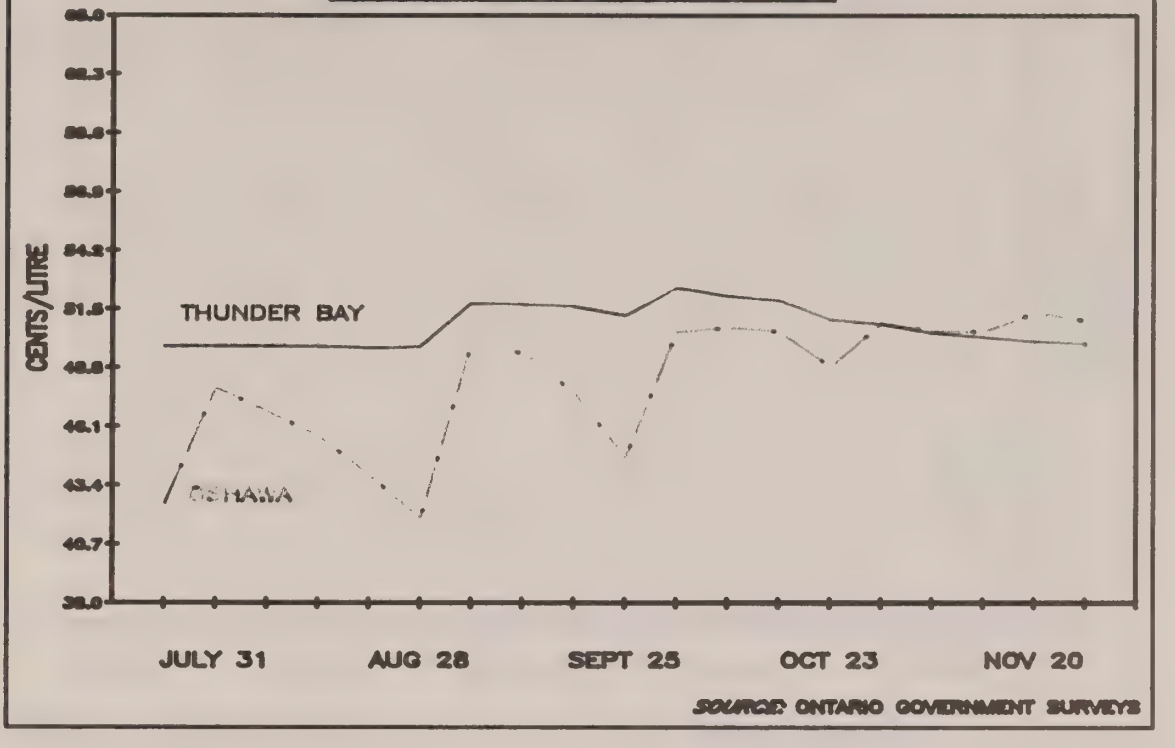


Figure 2.7
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES

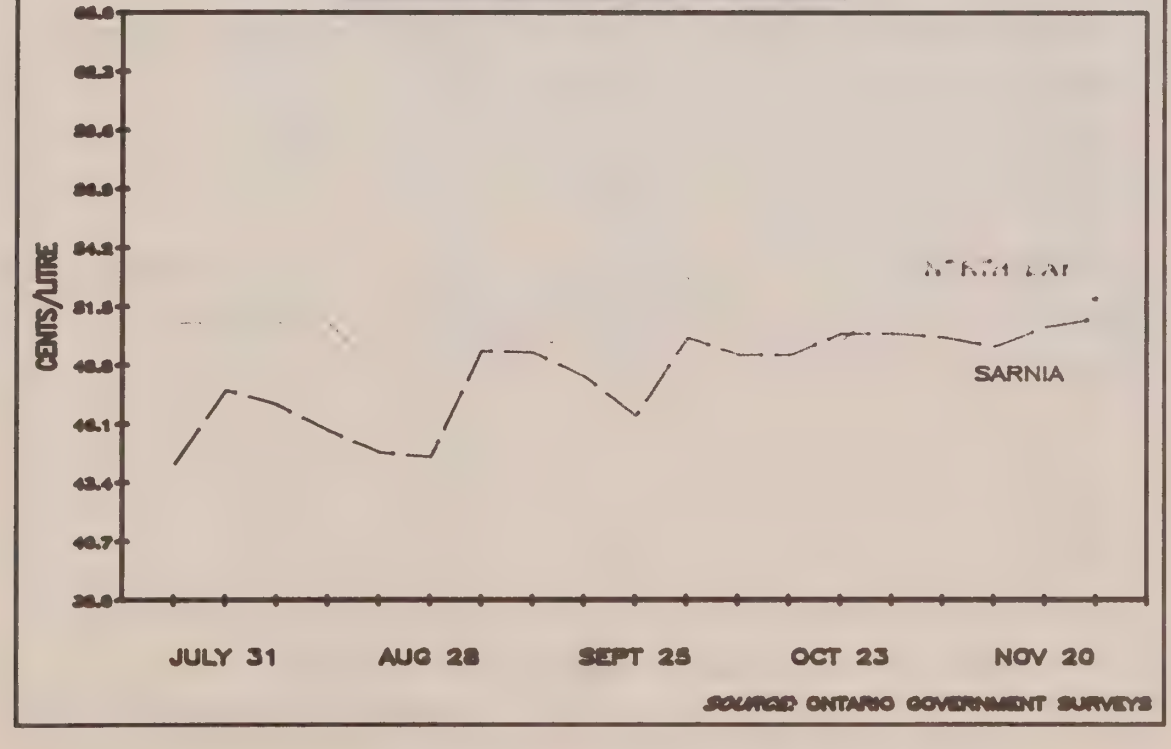


Figure 2.8
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES

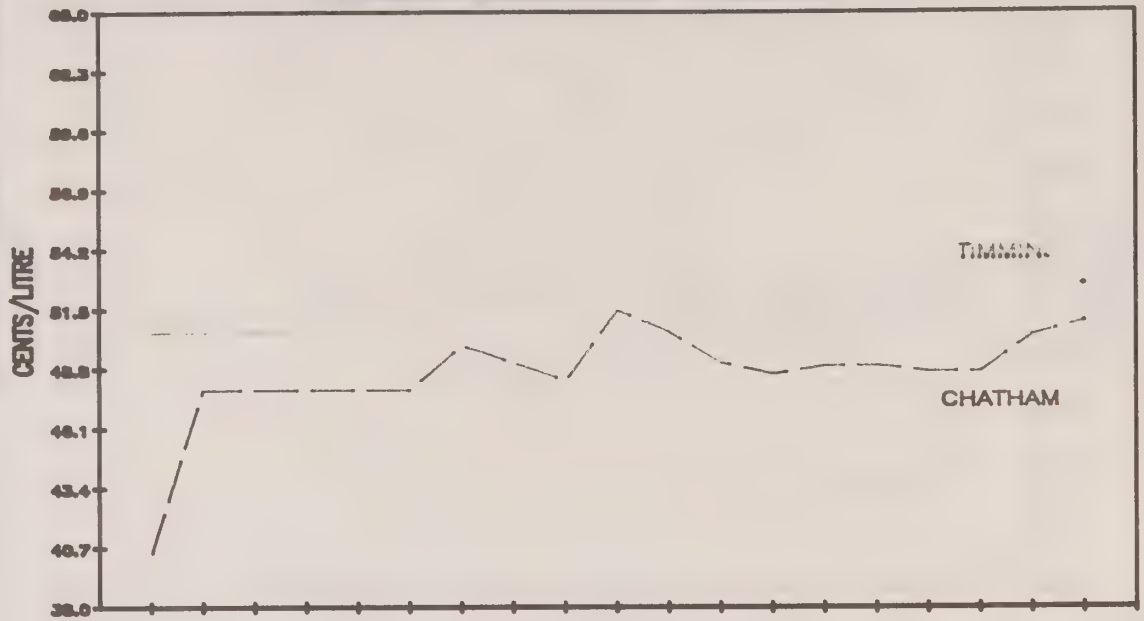
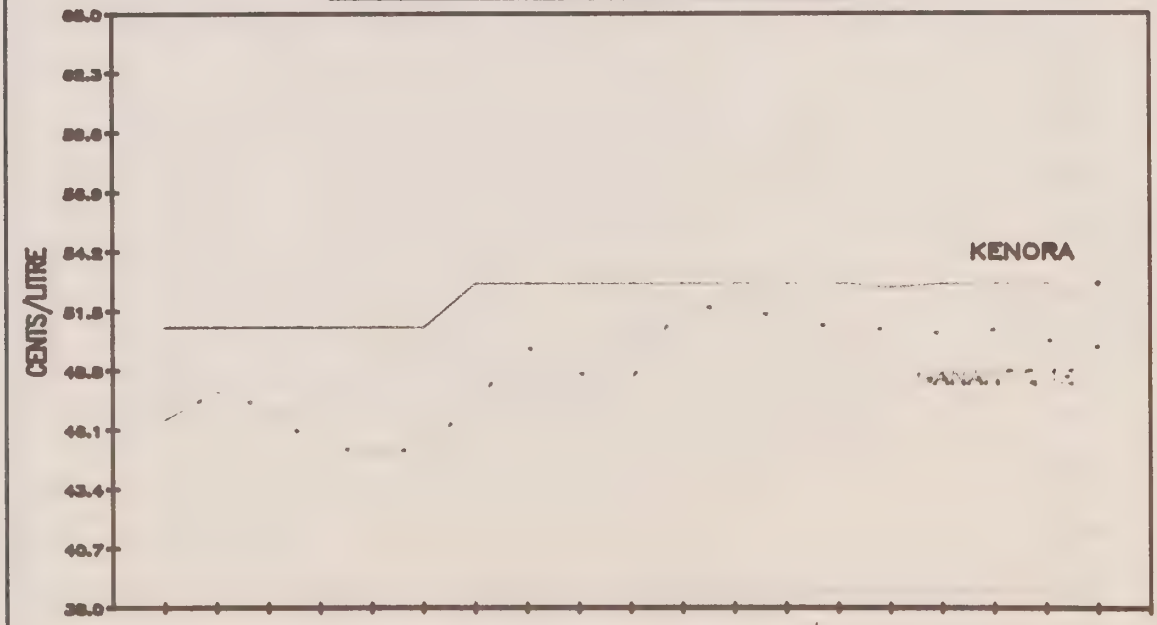


Figure 2.9
COMPARATIVE POPULATION CENTRES
RETAIL GASOLINE PRICES



The Impact of Higher Prices on Northern Motorists

The average personal use passenger vehicle in Canada was driven a distance of 17,130 kilometres in 1984 and consumed 2310 litres of gasoline according to Statistics Canada. Seventy five per cent of such vehicles drove less than 20,831 kilometres.

An upper limit of gasoline consumption by northern residents can be estimated by assuming that the average northerner drives a distance of 21,000 kilometres (i.e. at the seventy fifth percentile), and that the fuel efficiency of his car is ten per cent lower than the national average. On this basis average northern fuel consumption would be 3090 litres per year.

Over the period of the survey, prices in northern Ontario averaged 4.2 cents per litre more than in southern Ontario, although this difference was much smaller toward the end of the survey.

At a difference of 4.2 cents, the average motorist in northern Ontario pays an extra $130 a year as a result of higher gasoline prices.

Obviously, for a high mileage driver in a high-priced remote community, this average will considerably understate the extra costs incurred. However, for the majority of northern residents who live in the major urban centres, actual additional costs will be less than this average.

CHAPTER 3: THE COSTS BEHIND THE PRICES

HIGHLIGHTS

- Distribution costs to large stations in northern cities are about 1.5 cents per litre higher than costs to similar stations in Toronto.
- Distribution costs to smaller urban stations are typically higher by an additional 2 cents per litre.
- Distribution costs in more remote northern communities sometimes exceed Toronto area distribution costs by as much as 7 cents a litre.
- It is more expensive to deliver gasoline to smaller stations because their smaller tanks preclude delivery of a full truck-load.

PROCEEDS FROM THE SALE OF GASOLINE

When a litre of gasoline is sold for 50 cents per litre, the revenue is divided approximately as follows:

	Cents per Litre
Crude oil producer	17.3
Taxes on crude oil	8.0
Transportation of crude oil	1.1
Gasoline Taxes (Federal & Ontario)	14.7
Dealer	3.0
Refiner	7.9
TOTAL (Retail Pump Price)	50.0

During the period of the study, most dealers were guaranteed a fixed margin by their suppliers. Under this system, any change in the retail price is reflected in the refiner's share, as shown in Figures 3.1 and 3.2.

The revenue received by the refiner is used to pay the costs of refining, marketing and distributing gasoline throughout the province. Refining costs are the same, regardless of where the product is sold. They therefore have no direct impact on differences in costs or prices between northern and southern Ontario. A description of these costs is given in Appendix C.

Figure 3.1
REFINERY MARKUPS

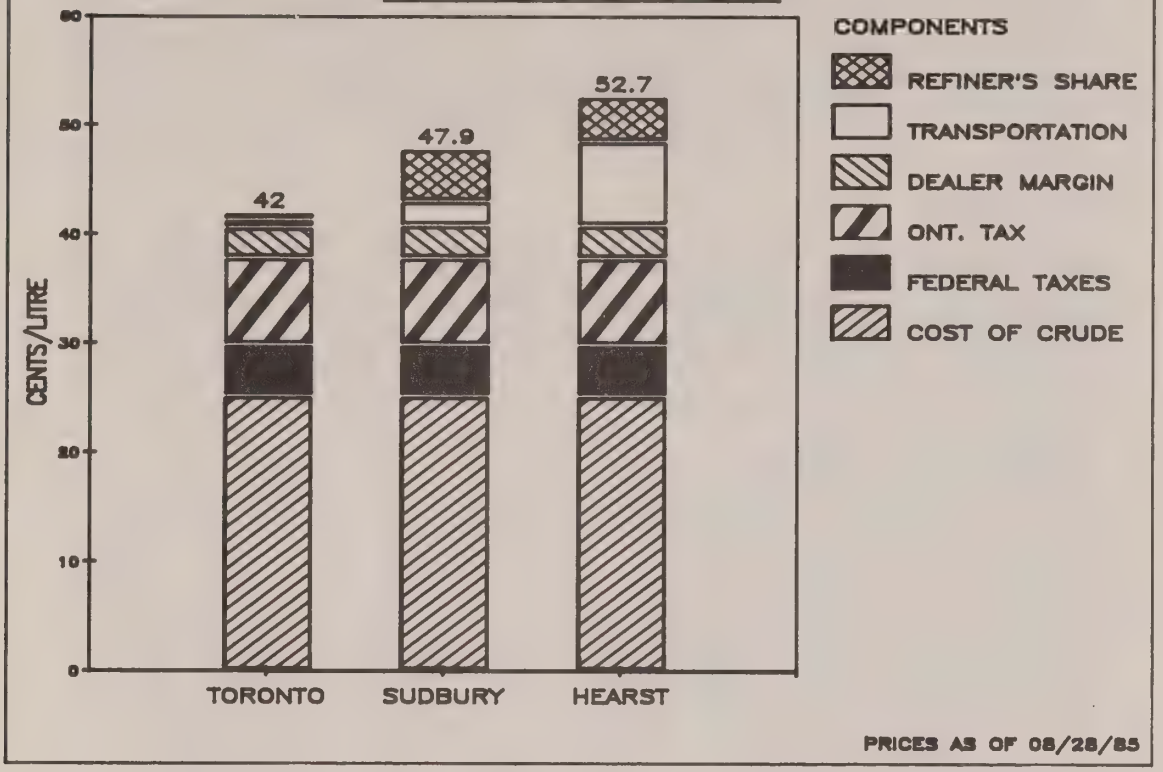
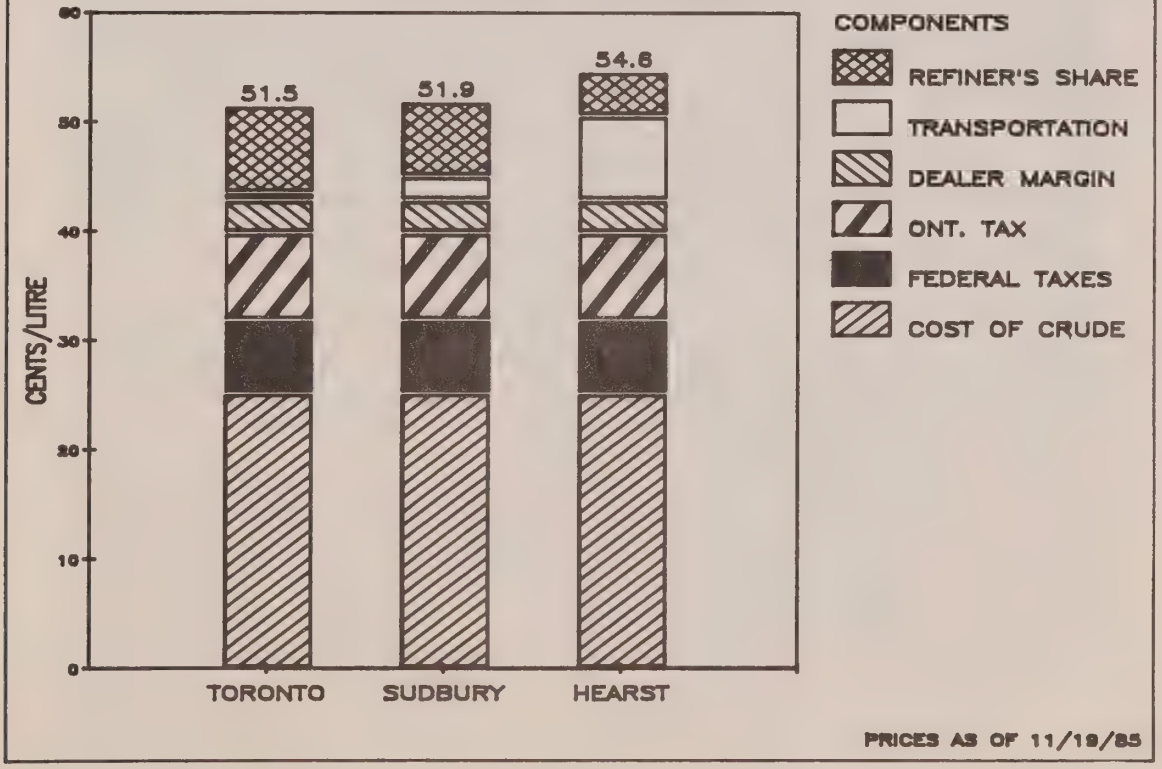


Figure 3.2
REFINERY MARKUPS



Under Imperial's new rack pricing system, changes in retail price are reflected in the dealer's share. However, wholesale costs will be adjusted to reflect market conditions, ensuring that refiners' margins will also be affected by price changes.

Marketing

The cost of marketing gasoline is centrally allocated. The information available suggests that the additional costs of northern Ontario marketing are not recovered in the higher retail gasoline prices in northern Ontario.

Distribution Costs

All Ontario refineries are located in the south. Gasoline is distributed to service stations in a number of ways as depicted in figure 3.3. Most stations in southern Ontario are relatively close to terminals supplied by pipeline. Northern Ontario is served by marine terminals in Thunder Bay, Sault Ste. Marie and Parry Sound as well as by truck and rail from southern terminals. The distribution system is described in more detail in Appendix D.

All the major oil companies maintain bulk plants throughout the province to deliver petroleum products to areas where direct deliveries are not feasible. These bulk plants are operated by agents who are paid a commission for selling and distributing branded products.

Most of these agencies were established primarily to serve the heating oil market. The contracts between the agent and the oil company are usually geared to heating oil sales. Gasoline deliveries represent additional business to the agent. He charges the oil company a competitive price for delivering gasoline to service stations in his area. In this case, competitive prices are those which match the prices offered by independent contract carriers.

In addition to the amount paid to the agent, the oil company incurs other expenses such as inventory costs. A part of the maintenance cost of the bulk plant would also be charged to gasoline sales.

Confidential data provided by the oil companies on their northern activities reveal considerable variation in distribution costs, depending on the capital investment that individual companies have made in specific locations. A company with the

cheapest distribution costs in one area often incurs higher-than-average costs in another. Generally, however, the costs of the most efficient distribution network in any area influence gasoline prices there.

Table 3.1, based on data from several companies, shows gasoline delivery costs for particular service stations in selected communities. These data suggest three conclusions:

- There are underlying cost differences between communities reflecting their geographic accessibility within the distribution network. On average, gasoline delivery costs to large stations in urban areas of northern Ontario exceed costs to stations in the Toronto area by about 1.5 cents per litre. For smaller stations in locations more remote from the large terminals, the cost of gasoline delivery is as much as seven cents more than in Toronto.

- Within each community costs vary for non-geographic reasons. In the Sudbury area, for example, agent deliveries are more expensive than direct deliveries from southern terminals. But they serve stations whose tank storage is too small to make direct delivery feasible. Thus local delivery costs are affected by the size of the drop.

- The costs of storage in terminals and bulk plants reflect not only the total operating costs of the facilities but also the volumes of gasoline over which these costs are distributed.

A concern expressed by northern residents is that price differentials between north and south are believed to be greater than could be accounted for by differences in distribution costs. Information provided by the refiners indicates just the opposite, that additional revenues resulting from price differences throughout northern Ontario are insufficient to cover the difference in distribution costs. Several refiners have stated that they realize less from their northern stations than they do from those in the south, indicating that, at the wholesale level, additional distribution costs are not recovered by the difference in prices. They argue that this reduction in profit, common to all of the national brands, results from over representation in the north for the purpose of being able to offer a coast-to-coast market presence.

The proliferation of stations above and beyond what could be supported by the market has led to inefficient retail operations, distributing the costs over a low volume of gasoline. This system requires higher margins to support it, resulting in higher retail prices.

COST TO SERVICE STATIONS IN:

CENTS/LITRE

TABLE 3.1

LINK	Toronto	North Bay	Sudbury	Sault Ste. Marie	Thunder Bay	Timmins	Hearst	Geraldton
Refinery to Toronto by pipeline (1)	0.2-0.5	0.2-0.5	02-0.5	N/A	N/A	0.2-0.5	0.2-0.5	N/A
Refinery to Marine Terminal (1)	N/A	N/A	N/A	2.0	2.0	N/A	N/A	2.0
Winnipeg to Thunder Bay (Rail)	N/A	N/A	N/A	N/A	3.5	N/A	N/A	3.5
Toronto to Bulk station(2)	N/A	2.0	2.0	N/A	N/A	2.0-4.0	3.0-5.5	N/A
Marine Terminal To Bulk Station(2)	N/A	N/A	N/A	0.5	0.5	N/A	N/A	3.0
Local Delivery	0.5	0.5	0.5	0.5	0.5	0.5-2.0	0.5-2.0	1.0
Direct Delivery Ex Toronto	0.5	2.0	2.0	N/A	N/A	N/A	N/A	N/A
Total Cost	0.7-1.0	2.2-3.0	2.2-3.0	2.5-3.0	2.5-4.5	2.7-6.5	3.7-8.0	6.0-7.5

Notes:

1. Including terminal throughput charges
2. Including bulk plant throughput charges
3. N/A: Not Applicable

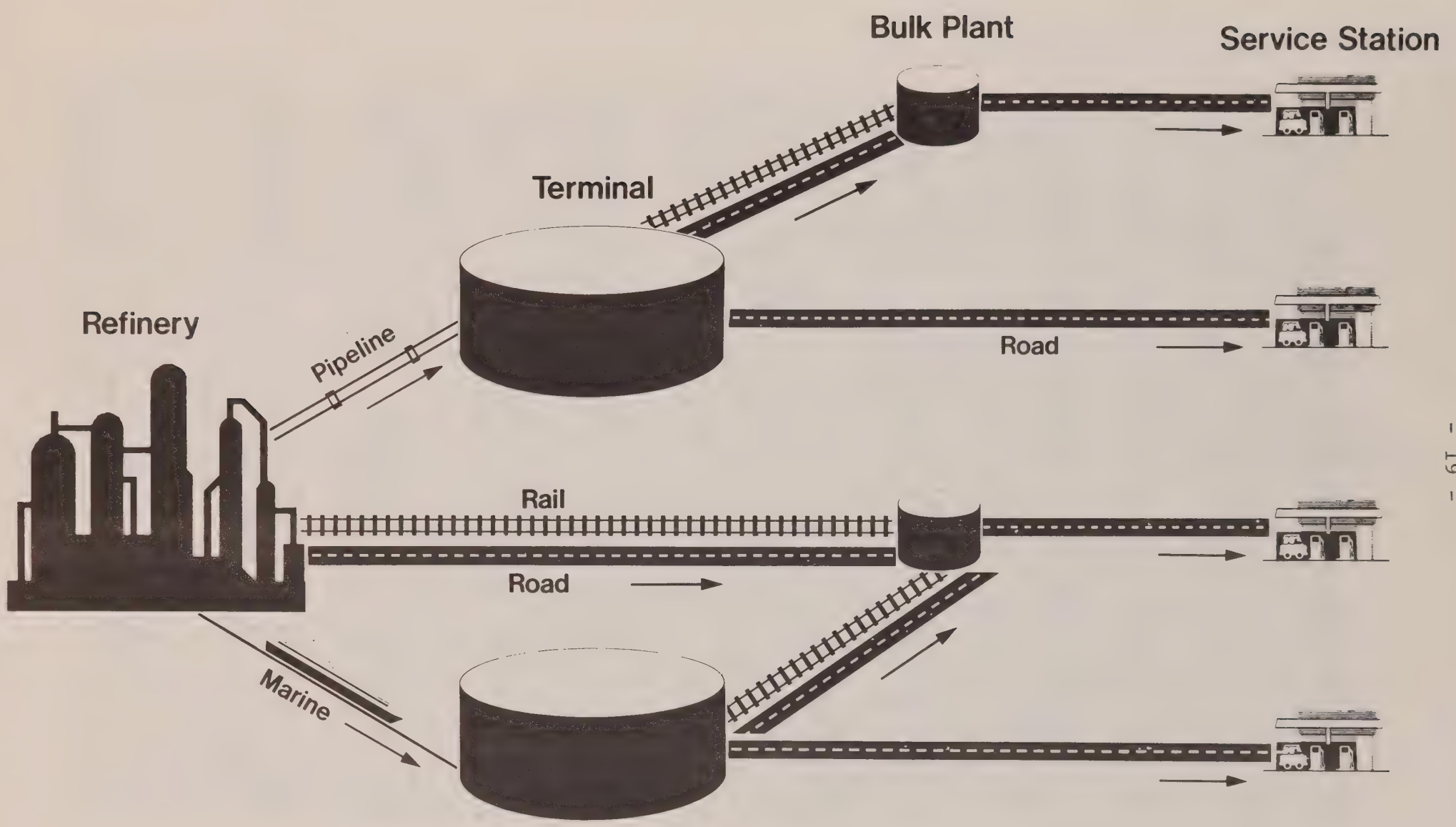


Figure 3.3

Gasoline Distribution Network In Ontario

CHAPTER 4: THE IMPACT OF REFINERS ON PRICE DIFFERENCES

HIGHLIGHTS

- Ontario has seven refineries operated by six companies, all located in southern Ontario.
- In general, the most aggressive refiners are more heavily represented in the south.
- Polysar does not operate a retail chain but sells exclusively to independents, mainly in the south.
- All the major refiners except Gulf operate "fighting" brands to compete directly with independents. Most of these second brand outlets are located in the high volume markets of the south.

THE REFINERS

One of the major differences between the northern and southern gasoline markets results from the different attitudes toward pricing of the individual refiners and the degree to which each is represented in different parts of the province.

Some refiners, as a matter of policy, are more aggressive on price than others. All refiners are intent on maintaining or increasing their volume of sales in order to keep their refineries operating at efficient levels. However, the importance of this factor relative to the need to maintain profit margins varies from company to company. Generally, refiners who seek to increase sales through aggressive pricing do so in large markets where any increase in market share will have a significant impact on volumes. As a result, the more aggressive pricers among the refiners have invested more heavily in the larger markets of southern Ontario than they have in the north.

By contrast, refiners whose strategy is to maintain profit margins on existing business are more heavily represented in northern Ontario. These include most of the national brands, who followed strategies of maintaining a presence from coast-to-coast, resulting in a large number of outlets in northern Ontario relative to the population.

While all refiners in Ontario sell gasoline to independent retailers, all, with the exception of

Polysar also maintain their own chains of branded outlets. With the additional exception of Gulf, all maintain outlets bearing a second or "fighting" brand which sells gasoline at prices designed to compete directly with the independents. Most of these second-brand outlets are located in the high-volume markets of southern Ontario.

Polysar does not maintain a retail distribution network. Gasoline is sold entirely through jobbers on a non-exclusive basis. Polysar has a relatively small list of clients most of whom operate almost exclusively in southern Ontario. Polysar is therefore not a factor in setting prices in northern Ontario. However, its presence in the south contributes to the differences between the two markets.

Polysar signs contracts with jobbers for the sale of gasoline for a fixed period of time. During intense price wars, when other refiners are supporting their own retail networks, Polysar is forced to offer price support to these independent jobbers in order to maintain its volume. This support allows the jobbers to compete with the major brands at lower price levels than would otherwise be the case.

WHOLESALE GASOLINE PRICING

Wholesale Pricing Systems

Dealer Tank Wagon Prices are official prices established by refiners for various classes of trade. Although they are adjusted to reflect market conditions, they are fundamentally cost related and proved to be unable to adapt to the intense competition of recent years. Discounts are negotiated on an individual basis.

Guaranteed Margins set wholesale prices in relation to the retail price. Dealers are guaranteed a set margin on sales of gasoline, regardless of the market price. The wholesale price is effectively the retail price less the guaranteed margin.

Rack Pricing, as recently introduced, establishes zone prices for various classes of trade. Volume discounts are available according to a fixed scale. Prices are adjusted to reflect market conditions. (See Appendix H for details).

Equalized Rack Pricing is advocated by various interest groups but not practiced. Gasoline would be available at the refinery to all customers at the same price regardless of volume.

During the period of the study, all Ontario refiners had similar systems by which gasoline was priced at wholesale. These systems set wholesale prices under "normal" market conditions, but allow retail prices to dictate the wholesale level under conditions of "depressed" prices, In practice, the so-called "depressed" prices are in fact the norm, and for most stations, wholesale prices are set in relation to prevailing retail levels. While this is true throughout Ontario, the incidence of full wholesale pricing is more common in the north.

The "official" or wholesale pricing systems are generally referred to as Dealer Tank Wagon Prices. Dealer Tank Wagon prices are essentially cost-oriented. The price is intended to recover costs and yield return on investment.

Though the official price is fundamentally cost-related, no refinery can afford to set a price that is substantially out of line with those of the competition. The result is that the official price charged in a zone by a refinery is sometimes inconsistent with its costs for that zone. Several refineries have stated that the total additional costs of deliveries to northern Ontario are not recovered in their official prices.

Price Support Mechanisms

In practice, few Ontario branded dealers pay the official wholesale price. Severe competition has generally undermined the ability of a dealer selling a refinery brand to earn a sufficient margin over the official price to cover expenses. Thus the refiners have been forced to offer price support to protect the economic viability of their dealer networks. Although at least 95 per cent of all refiner branded outlets in Ontario, including those in northern Ontario, are currently on some form of price support, the exceptions are more common in northern Ontario.

Through a variety of mechanisms, the refiners ensure that, regardless of retail prices, the dealer is guaranteed a set margin on every litre sold. The margin is currently about 2.8 to 3.0 cents a litre. Only rarely is the dealer allowed a higher margin when prices rise. A dealer receiving price support is thus protected from, and tends to become indifferent to the risks of falling gasoline retail prices.

Price support changes the relationship between refiners and their branded dealers. A dealer requesting price support becomes, in effect, the refiner's agent. The refiner has acquired an interest in retail price levels, and the dealer has sacrificed the right to establish his own prices. In theory retail prices are set by the refiner. In practice, they are dictated by the marketplace, because no refiner can afford to charge more than the current market price.

Dealers usually request price support when price levels drop to the point where the spread between the prevailing retail price and the Dealer Tank Wagon price is less than the margin that the refiner will guarantee. This implies that in high priced areas (those where Dealer Tank Wagon wholesale prices are charged), both the wholesale price and the retail margin are higher than in lower priced areas where price support is in effect.

Rack Pricing

Esso has recently introduced a system they call rack pricing which is designed to replace the current system of guaranteed margins. This system was not in general use during the period of the study and therefore did not affect price differences at that time. It is discussed in more detail in Appendix H.

PRINCIPAL BRANDS OF GASOLINE IN ONTARIO

Brand of Name Outlets*	Supplier	Status	Number
Beaver	Shell	Fighting Brand	70
Canadian Tire	Texaco	Independent	83
D-X	Various	Independent	79
Mr. Gas	Various	Independent	28
Husky	Exchange Agreements	Regional Refiner	44
Esso	Self-supplied(2)	Integrated Major	883(1)
Gain	Esso	Fighting Brand	(1)
Gulf	Petro-Canada	Bought Out	501
Petro-Canada	Self-supplied	Integrated Major	1005(2)
Pronto	Sunoco	Fighting Brand	40
Shell	Self-supplied	Integrated Major	1141
Rebel	Petro-Canada	Fighting Brand	(2)
Regent	Texaco	Fighting Brand	(3)
Sunoco	Self-supplied	Regional Refiner	487
Texaco	Self-supplied	Integrated Major	813(3)
Top-Value	Various	Independent	88
Ultramar	Esso by Exchange	Regional Refiner	206(4)
V-Plus	Sunoco	Management Contract	29
X-L	Ultramar	Fighting Brand	31

(1) Gain stations included in Esso figures.

(2) Rebel stations included in Petro-Canada figures.

(3) Regent stations included in Texaco figures.

(4) Includes stations displaying other brand names, including XL.

*Source: OilWeek Magazine, June 3, 1985

CHAPTER 5: DIFFERENCES IN THE RETAIL MARKET

DEVELOPMENT OF THE GASOLINE MARKETING NETWORK

HIGHLIGHTS

- The gasoline retail marketing network has adapted more quickly to changing conditions in the south than it has in the north.
- This has resulted in a more efficient network in the south.
- Dealers in the south tend to compete on price while those in the north rely more on service.

Historical Growth

The Ontario retail gasoline network developed largely in the period following the second world war. Refiners embarked on ambitious programs of building service stations to capture a share of the rapidly expanding market. When the market first peaked and then started to contract in the early eighties, the battle for market share became more serious. At the same time the advent of longer warranties, longer-life radial tires, and longer periods between scheduled maintenance work was depriving the service station owners of a large part of their non-gasoline related income.

Gasoline marketers responded by introducing self-service stations and gas bars and by cross-merchandising with other businesses such as car washes and convenience stores. These new facilities competed much more on price than had the traditional, full-service stations.

This process of change is continuing and will eventually result in a smaller number of stations, each selling a higher volume of gasoline. These changes occurred first in high-volume areas, where loss of market share would have the most serious effect on an individual refiner's gasoline sales.

As a result, stations which compete primarily on price are more common in southern Ontario then they are in the north. Where they do occur in the north, they tend to be in urban areas, resulting in price differences between cities and rural areas.

The development of the retail network and the resulting differences between north and south are given in more detail in Appendix E.

Types of Gasoline Retailers

Company Operated Stations owned by the refiners and operated by employees or by agents appointed by the refiner.

Branded Lessee Dealers who lease service station facilities from a refiner, display that refiner's brand and sign an exclusive supply contract.

Branded Independents who own their own facilities, but in other respects operate like branded lessee dealers.

Private Brand Independents which display their own brands. They may sign exclusive contracts with a refiner or buy wherever gasoline is the cheapest.

Private Retail Chains which sign exclusive supply contracts with a refiner but display their own brands.

Jobber outlets supplied by distributors who buy gasoline from a variety of refiners, usually at a major terminal, and distribute it to their own chains of retail outlets.

Fighting Brand Outlets which are usually owned and frequently operated by refiners and which display a second brand priced to compete directly with independents.

Retail Outlets

There are seven major types of retail gasoline stations in Ontario. They are not evenly distributed. In general, the most aggressive retailers in terms of pricing are more common in the south.

Refiner Operated Stations

Most refiners operate some stations directly, using company employees or agents hired for the purpose. Generally such outlets are in high volume locations where the refiners see it as being to their advantage to earn the retail margin as well as their usual wholesale mark-up.

Because they are concentrated in high-volume markets, these stations are more common in the south than they are in the north.

Independent dealers frequently accuse the refiners of discriminating against them by setting artificially low transfer prices for company operated stations. However, during the course of the study, no evidence was found of predatory or exceptionally aggressive pricing on the part of company operated stations.

Under the system of guaranteed retail margins which was prevalent through the study, it would have been counter-productive on the part of the refiners to engage in predatory pricing through these outlets, because the system allowed independent branded dealers to match any price without losing margin. Under the new system of rack pricing, this will no longer be true.

Branded Lessee Dealers

Lessee dealers form the largest of the seven groups. They are particularly predominant in southern Ontario where the refiners have invested heavily in the major market areas.

As a group, lessee dealers tend to be relatively aggressive for two reasons.

1. The system of quaranteed margins effectively allows them to engage in price war activity without incurring any of the risks associated with falling prices.

2. Since their rents are usually calculated on the basis of the business opportunity at the particular location rather than on a normal return on the refiner's investment, their expenses are low relative to dealers who must bear the full cost of financing their facilities. This cost advantage allows them to compete more aggressively on price.

All the refiners who operate retail chains identified this behaviour on the part of individual dealers as being one important cause of price wars.

This behaviour is more common in larger markets because the closer spacing of stations causes the impact of any change in prices to be felt more widely.

Branded Independents

Retailers who own their own premises but offer a major brand of gasoline are usually supplied under the same conditions as the refiner's leased stations. The only difference is that the operator does not pay lease costs to the refiner.

During conditions of extreme price competition, these dealers receive the same guaranteed margins as do the dealers operating company-owned stations. However, since they often bear the full cost of financing their facilities, they tend to be less aggressive on price.

Among branded stations dealer owners are more common in northern Ontario than in the south.

Private Brand Independents

There are many unbranded, independent operators in the market, particularly in northern Ontario. Such dealers buy gasoline wherever it is cheapest, but rarely buy enough to qualify for the discounts available to larger operators. Their wholesale costs are therefore quite high. To stay in business, they must pass through these extra costs to their retail customers.

Private Retail Chains

Several chains of outlets exist with exclusive supply contracts. Ordinarily, the outlets are operated by the chain itself or by the supplying refiner under contract. They receive price support from their suppliers and generally offer prices slightly below those offered by competing major brands. However, they are not particularly aggressive pricers, for two reasons:

1. Since they are usually operated corporately, there is no tendency for individual dealers to attempt to raise volumes by cutting margins, and

2. They are not faced with the same problems as refiners who must keep their refinery utilization levels high.

These outlets are normally located in urban areas where the market is more sensitive to price. There is no significant difference between north and south with respect to their numbers or modes of operation.

Jobbers

Several retail chains sign supply contracts with a number of suppliers. Many operate their own distribution systems, picking up gasoline at refiners' terminals and delivering it to their dealers either directly or through bulk plants.

Jobbers generally sign contracts with refiners which provide for discounts at higher volumes. Although they may sign contracts with several refiners, jobbers tend to purchase a majority of gasoline from one supplier in order to raise their volumes to the point where the maximum discount is available.

Jobbers tend to be extremely aggressive on price, because any increase in volume is reflected in their purchase costs by way of deeper discounts.

Usually jobbers do not receive price support or guaranteed margins from their suppliers. If the prevailing retail price falls, their margins are reduced. Polysar, however, does offer a limited degree of price support to its major jobber customers.

Jobbers concentrate in price-sensitive markets where discounters can offset low margins with high volumes. Only recently have they started to move into urban areas in northern Ontario.

DEALER ECONOMICS

HIGHLIGHTS

- Gasoline is more important to the southern dealer because, on average, volumes are higher in the south.
- The economics of gasoline stations are very sensitive to volumes.
- Most stations sell other goods and services in addition to gasoline.
- These other goods and services typically earn higher margins than do sales of gasoline.
- The relative importance of gasoline sales to the dealer determines his attitude toward pricing.

There are approximately 6,000 retail gasoline outlets in Ontario. Most of them also sell a variety of other goods and services which frequently contribute more to the overall business than do sales of gasoline. The relative importance of gasoline sales to the business enterprise is a key determinant of the attitude of the retailer to gasoline and has a major impact on the way gasoline is priced.

The effects of volumes on a dealer are given in more detail in Appendix F. They can be summarized as follows: If a dealer sells large volumes of gasoline, then gasoline sales are either his primary business or they attract customers to other enterprises. If the dealer's volume is small, then gasoline sales are merely one component of a diversified business. High volume dealers tend to be more aggressive on price, since the average southern station sells approximately 75% more gasoline than the average northern station, this factor alone has a significant impact on price differentials.

In southern Ontario, the average full-serve station sells enough gasoline to maintain a viable complementary business. Such stations are normally aggressive on price in order to attract more business. In northern Ontario, lower volumes weaken

the link between gasoline and other sales, and the dealers are less aggressive.

The economics of a self-serve station are quite different. Variable costs are lower because there is less labour, but capital costs are usually higher. Such stations normally do not have significant sales of products other than gasoline. They are located in high-traffic areas, because high volumes are required to justify the capital costs.

Most self-serve stations try to maintain a fixed price spread with respect to competing full-serve stations. This spread is curently around 0.4 cents per litre. Since self-serve stations are more common in the south, this also contributes to regional price differentials.

CHAPTER 6: MARKET FACTORS AFFECTING PRICE DIFFERENCES

HIGHLIGHTS

- The most important factor is the overall size of the market.
- Greater population density makes the southern Ontario market relatively homogeneous.
- In the north, greater distances divide the market into independent sub-markets.
- Larger markets attract a greater choice of brands including aggressive independents, a wider mix of services, and more price competition.
- Smaller markets tend to compete on the quality of service as opposed to price.
- Traffic flows are greater in the south and there are more customers per outlet.
- The oil companies have invested more in the south and may act more aggressively there to protect their investments.
- Distribution costs are higher in the north due to greater distances from the refineries.
- Retailing costs are higher in the north due to lower volumes.
- There exists in northern Ontario a large segment of the market that is relatively insensitive to price.

Market Factors

The preceding chapters have dealt with the supply of gasoline and described how the various wholesalers and retailers behave differently in northern and southern Ontario.

Partly resulting from these differences and partly causing them, the market itself is different from north to south.

Size of Market

The most significant single market factor affecting price differences is market size. Nearly all the factors which contribute to price differences between northern and southern Ontario are related to the size of the market.

The market size factor affects Ontario gasoline prices in two ways. First, taken as a whole, the southern Ontario market is much larger than that in the north. This fact alone tends to make southern prices lower. Secondly, the southern Ontario market is more of a unified whole, whereas northern Ontario consists of a number of smaller, comparatively independent markets. In southern Ontario small communities are rarely far from major urban centres or from tourist routes. They thus tend to reflect the prices prevailing in the adjacent large markets, so that substantial price differences between communities do not occur frequently.

Within northern Ontario by contrast, the price differences between large and small markets are much more noticeable. For example, the Thunder Bay and Sudbury markets generally exhibit fairly competitive pricing and occasionally experience mild price wars unlike smaller communities such as Chapleau and Hornepayne where much higher prices are common.

Exceptions to this general rule can occur because of other factors. In northern Ontario only four markets appear to be large enough to develop the increased competition normally associated with larger markets: Thunder Bay, Sault Ste. Marie, Sudbury, and North Bay. The Sault Ste. Marie market, however, behaves differently from the others because price-conscious customers tend to cross the border to buy gasoline in Michigan where prices are lower. In Sault Ste. Marie, only those customers for whom convenience or service is more important than price buy gasoline in Ontario. By contrast, several communities which are not large enough to generate active price competition on the basis of their size, nevertheless do have competitive markets as a result of other factors.

Traffic Flow

High traffic flows can push prices either way. In some localities, several dealers will struggle for marketshare. The total gasoline volume is insufficient to make it worthwhile to compete on price. Instead, dealers rely on repairs or special service to attract customers and charge relatively high prices for gasoline.

However, such locations are also frequent targets of the new wave of gasoline retailers who offer little or no service and compete on price. Such operators may build a low-cost gas bar requiring minimum staff on such a street, offer lower prices, and force the other dealers either to match prices or relinquish their gasoline market share. Such rationalizations have occurred more frequently in southern Ontario, where higher traffic flows have made such opportunities more common. But similar low-cost operations are moving into the larger market areas in the north.

Customers per Outlet

This factor is related to traffic past an outlet but also assumes greater significance in smaller, independent markets and relatively isolated communities where the service stations rely almost exclusively on local traffic. A prime example is Red Lake, which has six service stations serving a population of 2,165. The vehicle population is difficult to determine since it includes substantial numbers of boats, snowmobiles, and all-terrain vehicles as well as conventional automobiles and trucks. However, the ratio of vehicles to outlets is very low by any yardstick. Dealers survive because they offer a variety of services ranging from heating oil distribution to marina facilities. Gasoline volumes are low and sales would not be worthwhile in the absence of substantial margins. Prices are, therefore, consistently high.

By contrast, the average station in Toronto services 2,845 people, a figure more than 30 per cent greater than the entire population of Red Lake with its six stations.

Nature of Traffic

Whether the traffic past a station is local or long-distance can be more important than the total volume of the traffic. On an arterial road heavily used by commuters, prices are often relatively low. Motorists are unlikely to stop for repairs other than in emergencies. Dealers must therefore earn their living from gasoline sales. Price is their most effective competitive tool. Similarly, stations built along heavily travelled through highways tend to have competitive prices.

An exception to this generalization occurs along restricted access highways in southern Ontario. The rights to sell gasoline at service centres along these routes were determined through a tendering process. Recognizing the prestige value of having high-profile outlets along such heavily travelled routes, the refiners bid high prices for these rights. Overhead costs are, therefore, very high. At the same time, a large proportion of the traffic flowing past these stations is involved in long trips and requires refuelling somewhere along the route. A significant proportion of this traffic is not very sensitive to price. As a result, prices at such outlets tend to be relatively high.

Stations in towns off the major highways tend to offer full service and charge higher prices. A prime example is Highway 11 from North Bay to Cochrane. Prices are even and relatively low along the highway. In Cochrane itself, however, prices during the survey were 4.3 cents per litre higher.

Sometimes dealers catering to the two kinds of traffic are found in close proximity. Mattice, for example, has two stations. One is a full service station with two bays. The other is primarily a gas bar offering only minor repairs. The station offering full service usually charges a full 6 cents per litre premium over its competitor.

In the south the distinction between commuters and local traffic exists but tends to be obscured by other factors. Because on average the cities are larger, the average southern commuter travels farther to work than his northern counterpart. He can choose to purchase gasoline near home, en route, or at work. This greater choice makes the southern motoring public more price sensitive.

The wider range of alternatives available to southern Ontario motorists tends to increase competition between groups of stations as well as that between individual stations within a given group. Thus dealers in suburban areas are also competing with dealers along arterial roads and dealers in the downtown core. A similar phenomenon occurs with highway traffic, particularly along major highways leading from major urban centres to cottage areas. For example, competition between Toronto dealers and rural highway dealers extends as far north as Burk's Falls and Powassan, 300 kilometres from the city, and often leads to price wars along the routes.

Tourist traffic also affects prices differently in the north and the south. In southern Ontario the ratio of tourists to local traffic is lower, so that the tourist effect is less. Also, a greater proportion of the tourist traffic crosses the border frequently in the south. These travellers are less likely to purchase gasoline in Ontario because American prices are normally lower.

In northern Ontario a greater proportion of tourist traffic involves lengthy vacation trips that require gasoline to be purchased in Ontario. Often such tourists are more concerned with buying a brand that they recognize at stations that will accept their credit cards, than they are with the price of the product.

Refinery Costs

The cost for the refinery of making the gasoline is a very significant factor in the market. The economics of refining, like those of dealers, are very sensitive to volumes. Refineries are capital intensive, and the fixed costs are high. They will, therefore, go to great lengths to maintain their utilization rates at high levels. For this reason, at least in the short run, refiners tend to keep supplying product even if costs go up and prices do not.

The problem of maintaining refinery utilization rates is also affected by market size. A refiner who captures a larger share of a small market will do little to improve his operating efficiency. However, even a small gain in share in a large market can have a significant impact. Refiners, therefore, tend to be more aggressive pricers in large markets such as southern Ontario and more sensitive to price moves by others.

When suppliers are faced by increased costs such as the recent increase in the federal excise tax, they usually try to pass on the full increase to the consumer in the form of higher retail prices. The market resists this move and a flurry of price changes ensues which eventually results in prices which, while slightly higher than they were previously, do not recover all the additional costs. The gasoline market is better able to resist such increases in southern Ontario than in the north.

In southern areas, which often experience gasoline price wars, motorists are very responsive to prices. When prices are low, motorists fill up their tanks because they know that a price restoration will soon occur. When prices are restored, they delay fuelling and often purchase small volumes of gasoline in the expectation that prices will fall once again. In the short run, this lowers the volume of sales, raises costs, and prevents the refiners from passing on the full measure of any price increases. A description of how this occurs is included in Appendix G.

In northern Ontario, the market shows less price activity and is thus less able to discipline prices.

Choice of Brands

The greater the choice of brands being offered in the marketplace, the greater will be the level of competition. The variety is a sign of the extent to which competition involves refineries as well as individual dealers. Several of the major gasoline marketers that have a substantial impact in southern Ontario are either completely absent from, or very thinly represented in the north. For example, Petro Canada which, before its recent purchase of Gulf stations, already had the second largest number of branded outlets in Ontario, had only 25 stations in northern Ontario, eight of them in Sudbury and three of those at the same intersection! Ultramar, a company which operates a refinery in Quebec and markets products in Ontario via exchange agreements with other refiners, also concentrates its efforts in southern Ontario, as do most of the major jobber chains such as Suny's and Pioneer.

Even though some brands market almost exclusively in the north, the range of competitive brands available in the north is smaller than in the south. This factor was identified by several refiners as an important contributor to price differences. However, the influence of other factors was such that it was not possible to verify this from available data.

Availability of Independent Brands

In addition to the absolute number of different brands offered, the make-up of that number can be significant. Prices tend to be lower when independent brands are available. For example, areas served by jobbers tend to offer cheaper prices than areas served exclusively by branded outlets.

The struggle between refinery brands and jobbers is a frequent cause of price wars and thus lower prices. A recognized major brand can usually command a premium in the marketplace. To earn a share of the market, a jobber outlet must charge a somewhat lower price. If he is too successful in capturing market share, the branded dealers will react by lowering their prices. Sometimes an uneasy truce results in the discount offered by jobber outlets remaining stable over extended periods. Sometimes, and often in certain areas, the struggle between the two kinds of dealer is constant. This behaviour occurs much more frequently in southern Ontario where jobber outlets are more common.

Individual non-branded dealers often have exclusive supply contracts with one or another of the refiners and tend to be less aggressive on price. Such stations pay less than branded dealers for their gasoline because they are not charged for advertising and other expenses involved in maintaining the brand. In other respects they are treated much like branded dealers and sometimes receive price support from their suppliers in the event of price wars. These dealers may be individual stations or they may be chains of outlets such as Sears, V-Plus, and Canadian Tire. These stations, though independently owned, are closely tied to the refiners by their supply agreements.

While all kinds of dealers are found in both northern and southern Ontario, the aggressive jobbers represent a smaller proportion of outlets and less aggressive individual independents a greater proportion in the north than in the south.

Ownership Of Branded Stations

The distinction in branded stations between lessee dealers and independent owners may contribute to regional price differences.

When stations are leased the rental payments are set to reflect the total business opportunity estimated for a location. The payments are not related to, and are usually lower than, an appropriate return on the refinery's investment. This is the case even in areas where business opportunities are particularly great, because in such areas property values also tend to be high. In other words, lessee dealers are, in effect, subsidized by the refineries.

The refineries must make up these subsidies by raising their wholesale gasoline prices, which are charged to all customers. The branded independent owners must pay these higher prices while financing their stations at full cost. In doing so they help subsidize the lessee dealers.

Regional implications arise from the fact that among branded stations lessee dealers are less common and independent owners more common in the north than in the south. Thus, a lower proportion of branded stations is subsidized in the north than in the south, while a higher proportion contributes to the total subsidy.

The effect of this factor is largely theoretical, since there are no data available on what would happen if full economic rents were charged. It has been identified in several previous studies as a major factor (see for example the report of the 1975 Ontario Royal Commission) and dismissed by others as a myth (see U.S. Department of Energy, "Deregulated Gasoline Marketing").

Proximity of Alternative Sources of Supply

A variety of gasoline suppliers improves the bargaining position of independent dealers. All Ontario's refineries are located in the south. In addition, southern retailers have access to products from refiners and terminals in the adjacent states. This access does not affect branded dealers, who are tied to one supplier for their product. However, independent dealers in the south are far more able to negotiate with refiners by playing one off against the others than their more remotely located counterparts in the north. For example, Petrosar, which markets gasoline exclusively through independent resellers, finds nearly all its customers in southern Ontario.

There have been allegations made that some gasoline is entering Ontario mislabelled as fuel oil. This product would then not pay road taxes, although the retailers would charge the full price for the product. This practice is alleged to occur with some frequency at border crossings at Niagara Falls and Fort Erie, and occasionaly at Ivy Lea, Windsor, Sarnia, and the Lakehead. The Ministry of Revenue is currently investigating these allegations.

Obviously, access to product on a tax-free basis would have a serious effect on the local price structure.

CUSTOMER BEHAVIOUR

HIGHLIGHTS

- The gasoline market in segmented, with some customers buying on the basis of price and others on the basis of service.
- Motorists in southern Ontario are generally more price sensitive than those in the north.
- In the north, there is a larger service oriented customer base, allowing dealers to charge higher prices.

CUSTOMERS

Gasoline prices are ultimately determined by the interplay of supply and demand. Refiners, jobbers, and retailers represent the forces of supply. Equally important, however, is the role of the consumer on the demand side.

Price Sensitivity

Consumers on average are relatively insensitive to overall price levels. A change in price of 1 cent per litre will cost the average motorist about $25.00 per year. This is rarely enough to cause a motorist to change driving habits. Large increases in price do have a depressing effect on demand but only over a long time period. The increases in prices that followed the oil price shocks of the seventies slowed the growth in demand, but volumes did not peak in Canada until 1980. Since then, changes in driving habits and more fuel-efficient cars have reduced demand steadily.

Though motorists do not alter their driving habits because of price changes, they can be extremely sensitive to differences in price among competing brands. This sensitivity varies over time and among regions. To a certain extent, high levels of sensitivity are self-perpetuating. The retailers in price-sensitive areas are forced to compete on price. If one dealer attempts to increase market share by discounting the price, the others must react quickly or fall behind. Motorists in such areas reward discounters by giving them their business. Aggressive pricers therefore gain market share.

Market Share

As we have seen, some marketers are less aggressive than others, often allowing competitors a substantial price spread. In price-sensitive areas, this spread is enough to cause substantial shifts in market share. Eventually the high-priced marketer must allow his dealers to lower the price in order to keep them operating.

Under the current system of guaranteed margins, a price reduction by the major brand which has resisted lowering prices the longest is a signal for a renewed round of price reductions. The "market" price at which the refiners will guarantee their set margins is revised downwards. Aggressive dealers know that they can gain market share by lowering their margins, and a new downward cycle begins.

Eventually, the price becomes so low that one or another of the refiners seeks to re-establish prices at a higher level. This is done by raising the price at which the margin will be guaranteed to the retailers and hoping that other marketers will follow suit. The other marketers generally do follow, but the time lag results in lost business for the first marketer to move. Refiners are therefore reluctant to be the first to raise their prices. Some have strategies which call for them to be the second or third to raise prices.

Price Wars

In areas where price wars occur frequently, motorists come to expect them. After price restorations they delay purchasing gasoline. Frequently, when they do make a purchase under such conditions, they buy small volumes rather than filling their tanks. This short-term drop in demand also puts downward pressure on prices and helps initiate a new price war cycle.

Distance between Stations

Where there are many stations in close proximity, each prominently displaying its price, the customer tends to become price-sensitive. Where the stations are spaced further apart, making it more difficult for the customer to compare prices, price sensitivity is lowered. Greater distances between stations also imply that consumers will have to travel further out of their way in order to take advantage of any lower prices that do occur.

Choice of Service

In areas where a wide variety of specialty maintenance services is available, consumers tend to rely less on the local service station for repair work. They buy gasoline at self-serve or discount outlets and are more sensitive to price.

The consumer is the ultimate arbitrator of price spreads within a market. Outlets offering different brands or levels of service are constantly struggling for market share. It is the consumer who determines what price will be paid for these additional levels of service.

In the competitive markets of southern Ontario, these spreads are very narrow, indicating a customer population that is extremely sensitive to price. For example, price differences between adjacent full-service and self-serve major brand outlets during the period surveyed were normally 0.2 cents per litre in southern Ontario. Independents, whether full- or self-serve, offered prices about 0.2¢ below the major brands, self-serve price. These spreads have since increased to about 0.5¢ per litre between full- and self-serve. There was virtually no price spread apparent among stations offering various other services even though the presence of such services often increases the volatility of the market.

In urban areas in northern Ontario, the spreads between full and self-serve outlets are similar or slightly wider than in the south, indicating that, on average, consumers are not as price-sensitive. For example, during the survey period, the average difference between full-serve and self-serve outlets in Sault Ste. Marie was 0.4 cents per litre. Independents were priced 0.4 cents per litre below the self-serve price.

Outside urban areas, self-serve outlets are very rare in the north, because the volumes needed to support such outlets are not available. However, there is a wide variation in the level of service offered, from gas bars selling only gasoline to outlets offering full maintenance and repair services, often operating a tow truck. Price spreads of as much as 6¢ a litre were observed between stations in the same community offering different levels of service. This implies a clear-cut segmentation of the market. Some consumers are willing to pay a substantial premium for their gasoline to a dealer who will also provide them with

dependable service. Other consumers are more interested in saving money on gasoline sales. The result is that both stations are able to exist in close proximity.

Upcoming Developments

Several recent developments are certain to have an impact on the future market for gasoline in Ontario and to affect differences in price from one part of the province to another. Because the effects of these developments have not as yet been fully felt, their impacts are not discussed in the study.

The most significant of these developments are:

- The move to rack pricing
- The Petro-Canada purchase of Gulf Canada assets
- The increased exposure to international events resulting from the Western Accord.

The implications of these developments for the marketing of gasoline in Ontario are discussed in Appendix H.

CHAPTER 7: OTHER STUDIES AND OTHER JURISDICTIONS

HIGHLIGHTS

- Many other provinces have been concerned with inter-regional price differences.
- Where regulation has been imposed, prices tend to be higher.
- Most jurisdictions identify inefficiencies in their marketing systems, but there is little agreement on remedies.
- The Ontario Royal Commission of 1975 concluded that Ontario consumers are well served.

Several studies of gasoline marketing and prices have been conducted in Canada. These were examined during the course of the study and the findings and recommendations were examined in light of what had been learned of the Ontario market.

Summaries of these studies are presented in Appendix B. However, their salient features are discussed below in relation to the Ontario situation.

The Royal Commission on Petroleum Products Pricing

Particular attention was paid to the 1975 Ontario Royal Commission on Petroleum Products Pricing (The Isbister Commission), because it was the only study which dealt specifically with the Ontario experience.

The principal conclusion of the Commission was that the oil industry in Ontario is competitive and with respect to prices, consumers are being well served. However, it did identify several factors which it believed lessened competition in the market place.

These were:

1. The difference between posted wholesale prices and prices actually realized by the refiners (ie. the practice of guaranteeing retail margins).

2. The difference between wholesale prices to dealers and retail prices at company operated stations (ie. the practice of selling gasoline through company-operated outlets at retail prices below the wholesale price available to independents).

3. The practice of charging less than economic rents for company owned stations leased to dealers, which was seen as possibly discriminating against small northern towns.

The practice of guaranteeing retail margins has spread since the Commission issued its report. The effect of this has been to increase the amount of competitive price activity in the marketplace. However, the incidence of price activity is not uniform, and the practice contributes to differences in prices among regions. The practice also discriminates against independents who do not usually have guaranteed margins available to them.

Imperial Oil is attempting to introduce a system of rack pricing into the market which, if successful, would eliminate guaranteed margins. If this practice is adopted by the other oil companies, then the Commission's first concern will have been resolved.

The practice of supplying company operated stations with gasoline at artificially low transfer prices is not feasible when such prices are also available to all branded dealers through guaranteed margins. While the practice does not appear to be widespread now, it could become so under rack pricing.

The practice of charging lessee dealers less than economic rent for the use of service station properties is still widespread. However, in a market driven system, particularly one characterized by guaranteed margins it is not clear that the oil companies are able to recover the costs of any rent shortfalls through higher gasoline prices.

The Restrictive Trade Practices Commission

The Director of Investigation and Research of the Federal Department of Consumer and Corporate Affairs, after a study lasting seven years, published allegations in 1981 that the major integrated oil companies had engaged in a variety of anti-competitive practices which had resulted in Canadian consumers being overcharged by $12.1 billion dollars over a period of fifteen years.

The Director also published a variety of recommended remedies. The most significant of these, in terms of their impact on gasoline price differentials in Ontario were:

1. That exclusive dealing in motor fuels be prohibited. This would allow all retailers, regardless of the brand they were displaying, to purchase gasoline from any source.

2. That suppliers of motor fuels be prohibited from obtaining direct or indirect control over retail prices at any outlets other than those which they themselves operated. This would effectively eliminate consignment selling and guaranteed margins.

Nova Scotia: Report and Recommendations on Gasoline Marketing

Nova Scotia published a study in 1976 which concluded that the distribution of gasoline in the province was not efficient in that the resources employed in the industry were under-utilized.

Nova Scotia regulates the wholesale gasoline price in the province by requiring wholesale price changes to be approved by the Public Utility Commission. The PUC also regulates allowable retail margin. The study recommended that wholesale prices be rolled back to reflect the amount of rental subsidy that was deemed to be being recovered through higher gasoline prices.

The study also recommended strict limits on wholesaler operation of retail outlets, controls on discounts off posted prices to dealers and the banning of consignment sales.

Nova Scotia imposes severe limits on the flexibility of gasoline retailing. In addition to regulating wholesale prices and maximum retail margins, the province prohibits self-serve stations and gas bars and controls hours of operation. A recommendation in the study to allow self-serve stations was not adopted.

It is interesting to note that, net of provincial taxes, retail gasoline prices in Nova Scotia are consistently among the highest in the country.

Manitoba

Manitoba published a study in 1983 which examined price differences between Manitoba and northern communities. The study identified higher base costs, freight, bulk station costs and competition as factors contributing to higher wholesale costs. Higher retail margins in the north were attributed to lack of price war activity, smaller sales volumes, higher costs and less price competition.

Quebec

Quebec has undertaken two studies in recent years. The first, published in 1978, examined price differences between regions. It concluded that the best way to realize lower prices was for consumers to keep an eye on prices.

The second study, published in 1984 was prompted by the fact that a reduction in provincial road tax from 40% to 30% had not led to a corresponding decrease in prices.

Both studies recommended that price controls not be implemented, although it was pointed out that legislation enabling such control was already in place.

Alberta

The Alberta government has made a political promise to keep the retail price of gasoline the lowest in the country. This is achieved by not charging a road tax.

A study was published in 1965. It recommended that the refineries be divorced from retail operations. It also identified inefficient marketing resulting from too many stations as a factor which drove up the retail price.

Since 1965, the service sector population has been reduced from 3100 to about 2000. Voluntary lease guidelines have been imposed but no move toward divorcement has been made.

British Columbia

British Columbia published a report in 1975 which identified an excess of service stations as being a major cause of high prices. It recommended limiting the number of subsidized stations operated by each company and limiting the amount of gasoline that

could be sold directly by the major companies in each market area. Gasoline was to be sold at the same price to all dealers, regardless of whether they were lessees or independents.

United States

The United States Department of Energy published the draft of a report in 1984 entitled "Deregulated Gasoline Marketing - Consequences For Competition, Competitors and Consumers". The report strongly suggested that there was no alternative to the competitive process in terms of benefits to competitors and consumers.

Italy

Several countries in Western Europe regulate gasoline retailing. Italy, for example, maintains a common retail price throughout the country.

The effect of this regulation has been to concentrate private sector retail activity in low cost, high volume markets, effectively lowering the level of service available in rural areas. The unprofitable markets were abandoned by the private oil companies to the extent permitted by the regulations, leaving the national oil company with the burden of servicing the market at a loss.

The government has identified this situation as being unacceptable, and is examining ways of deregulating the market.

CHAPTER 8: SUMMARY AND CONCLUSIONS OF THE STUDY

PRICE DIFFERENCES

On average, prices for gasoline are lower in southern Ontario than they are in the north. There are two components of this difference.

1. The underlying price is lower in the south.

2. The south is more prone to price wars, which often lower the price far below normal levels.

In addition, there are large differences in prices between various communities in northern Ontario.

MAIN REASONS

A large number of factors influence prices at any given location. However, these factors can be grouped broadly to arrive at three fundamental reasons for the differences in prices:

1. Market conditions, principally the overall size of the market,

2. Wholesale costs, largely the cost of transporting gasoline from southern refineries, and

3. Retail costs, caused mainly by the fact that the average volume per service station is lower in the north.

Market Conditions

The study shows that the larger the market, the more intense is price competition within it. The gasoline market in northern Ontario is far smaller than the southern market. Furthermore, geography has split it into many small remote markets. The smaller and more remote they are, the higher is the price level and the less frequent is price competition.

The major oil companies differ in their attitudes toward market share and margin. Some have adopted a strategy of maintaining market share even if this has a severe impact on short-term margins and profits. Such companies state that this strategy will pay off in the long run when prices stabilize. Other companies try to maintain prices, and therefore margins, even though the result is a loss of market share. Such companies state that they

believe market share represents only a temporary advantage since consumers no longer have any significant loyalty to particular brands. Nevertheless, even these companies are not indifferent to volumes because they need to maintain their dealer networks and sell their production of gasoline.

The competition for market share is always most severe in larger markets where a small increase in share results in a significant increase in volume.

The Ontario retail gasoline network developed largely in the period following the second world war. Refiners embarked on ambitious programs of building service stations to capture a share of the rapidly expanding market. When the market first peaked and then started to contract in the early eighties, the battle for market share became more serious. At the same time the advent of longer warranties, longer-life radial tires, and longer periods between scheduled maintenance work was depriving the service station owners of a large part of their non-gasoline related income.

Gasoline marketers responded by introducing self-service stations and gas bars and by cross-merchandising with other businesses such as car washes and convenience stores. These new facilities competed much more on price than had the traditional, full-service stations.

This process of change is continuing and will eventually result in a smaller number of stations, each selling a higher volume of gasoline. These changes occurred first in high-volume areas, where loss of market share would have the most serious effect on an individual refiner's gasoline sales.

As a result, stations which compete primarily on price are more common in southern Ontario then they are in the north. Where they do occur in the north, they tend to be in urban areas, resulting in price differences between cities and rural areas.

During the high growth period, the major national brands of gasoline - Shell, Esso, Gulf, and Texaco - all followed strategies which called for a coast-to-coast presence. This resulted in stations being built even where the size of the market could not justify so many outlets. As a result, the average station in northern Ontario services only

about 50 to 60 per cent the number of customers of its counterpart in the south. Most of the costs involved in running a service station are fixed and must be spread over whatever volume of gasoline is sold. Low-volume stations therefore have far higher per-litre costs than do high-volume outlets and require higher margins to remain in business.

The gasoline market in Ontario is extremely competitive, putting severe pressure on both refiners and retailers. In order to protect their dealer networks, refiners have resorted to a number of mechanisms, such as plans which guarantee the dealer a set margin on gasoline sales regardless of how low the market price drops. Originally designed to protect dealers caught in short-term, local price wars, the practice has spread to the point where the vast majority of major-brand dealers throughout Ontario are now selling gasoline in this way. These dealers are removed from any effective control over prices, which are set by the refiners according to their estimates of local market conditions.

These conditions differ from one part of the province to another. Despite the fact that there are more stations per capita in the north, population densities are such that stations tend to be much farther apart than in the south. Differences in prices from one station to another are therefore more noticeable in the south, forcing dealers to compete on price. By contrast, if a northern dealer offers a higher price than his competitor, his volume will not decline as much as in the south.

Wholesale Costs

All Ontario's refineries are located in southern Ontario. On average, therefore, markets in the south are closer to the sources of supply than are those in the north. Because northern Ontario is large and sparsely populated, transportation and distribution costs are higher there.

Retail Costs

Few dealers rely exclusively on sales of gasoline. Most offer a variety of other products and services which usually earn a higher percentage margin. Gasoline sales attract customers to the business and allow the dealer to increase profits on the sale of other products. At very low volumes of gasoline,

the amount of business so attracted is insufficient to maintain the enterprise. The dealer in this situation is forced to devote a large percentage of his effort to the management of the other business, and gasoline sales come to be of relatively minor importance.

Many outlets in northern Ontario, particularly those located in rural areas, have volumes which place them in this category. Dealers in such outlets tend not to be aggressive in pricing because the additional volumes sold by reducing prices are not usually sufficient to compensate for the lower margins. On the other hand, many dealers in southern Ontario are aggressive pricers because additional volumes, even at low margins, result in more sales of products other than gasoline which yield higher margins.

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